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E.O. 12958: N/A
TAGS: EFIN ECON PGOV FR
SUBJECT: THE SPIRALING PUBLIC DEBT, Part I

¶1. SUMMARY. A government-commissioned report has warned that the current financial situation could spiral out of control unless a freeze is put on government spending over the next five years. The report recommendations are likely to become an issue leading up to the 2007 presidential elections. END SUMMARY

Public Debt Surges

¶2. After the June 2005 government cabinet shuffle, Finance Minister Thierry Breton commissioned Michel Pebereau, the CEO of BNP Paribas Bank, to produce a report meant "to launch a debate on public debt and its consequences on France's economic policy." To avoid having his report ignored for presumed bias, like the previous October 2004 Camdessus report ("Toward a new economic growth for France"), Pebereau formed a 20-member non-partisan group of both center-right and left politicians, senior civil servants, economists, and businessmen, pointing out that "it is just good sense, this report will be neither center-right or leftist." The report was published on December 14, 2005, and appears to have avoided the fate of previous reports. It highlights the tripling of the French public debt over a 25 year period, from 20 to 66.5 percent of GDP, or from roughly 91 million euros in 1980 to 1.1 billion euros in 2005. The growth in French debt over the last decade was faster than in any other industrialized country. Public debt increased significantly faster than GDP, making France one of the most indebted European countries along with Italy (108.6 percent of GDP), Greece (107.9 percent), Belgium (94.9 percent), Malta (77.2 percent), Cyprus (70.4 percent), and Germany (68.6 percent). More alarming still, when French public debt is calculated including other government liabilities, such as civil servant pensions, it is closer to 100 percent of GDP.

Unwillingness to commit to painful reforms

¶3. Debt accumulation in the last twenty years was not due to lower economic growth or high interest rates, but to a lack of fiscal restraint. The spectacular debt increase was primarily attributable to the ever-expanding ranks of the civil service and their pension liabilities. Pebereau did not mince words, saying that "debt has neither spurred economic growth nor reduced unemployment - it has slowed economic growth." Debt service (40 billion euros), the area of largest government spending after education and before defense, considerably reduced government investment opportunities. Government spending accounted for 54.0 percent of GDP, compared with 48.6 percent in the euro zone and 40.8 percent in the OECD. France also had the highest level of taxation in the G7 as a percent of GDP (44.1 percent).

¶4. The report put the blame on a series of administrations "that have all taken the easy option of public borrowing," noting that

France failed to respect its commitment to reduce the budget deficit to below the EU limit of 3.0 percent of GDP, this due in large part a reluctance to trim the civil service. The number of civil servants actually increased 14 percent from 1982 to 2003 during the government's "decentralization" program by which Paris sought to transfer certain responsibilities from the central government to various local entities.

Report urges government action

¶5. The report called for immediate initiatives, without which the government would "lose control of the financial situation." Soaring debt placed "a serious risk on France's future," and the burden will only worsen due to the country's aging population. Payments of retirement pensions by the central and local governments to their direct employees alone will account for 0.65 percent of GDP as early as 2015, a figure that will rise to 20 billion euros per year in ¶2020. Payments of health insurance benefits will amount to 22 billion euros per year in 2015 as well. Increased debt service due to higher budget deficits will amplify the vicious cycle of budget deficits, national debt, interest rate hikes, and debt service. The result in the medium term would be double-digit interest rates, high inflation, significant cuts in pensions, and possible emigration to countries with better economic situations.

¶6. Not surprisingly, the commission argued strongly against:

(a) continuing to add to the public debt.
Raising interest rates indefinitely is not an option; an increase, even by as little as 1.5 percent by 2008, for example, would require an additional 33 billion euros to stabilize the debt by 2012. Public debt would surge to 130 percent of GDP in 2020, 205 percent in 2030, and close to 400 percent in 2050, and at some point before that happened, "the government would lose the trust of financial

markets." The Standard and Poor's rating agency said in December 2005 that it would not rule out downgrading France's debt if nothing is done to correct the situation;

(b) falling back on the Pension Reserve Fund ("Fond de Reserve des Retraites") or possible surpluses in the Unemployment Insurance Fund and Family Allowances Fund, as any possible gains from these resources would be insufficient to reduce budget deficits in any considerable way; and,

(c) increasing taxes or other "social contributions," the logic being that it would harm economic growth and make France less competitive.

The Solution: a Freeze on Government Spending?

¶7. The report recommended "balancing the government budget within a period of five years," a gradual move that arguably makes the objective achievable without hindering further economic growth. (It should be noted that presidential terms in France are now five years).

Recommendations include:
(a) freezing central government budget spending in euros, equivalent to a 2 percent annual cut after inflation. Over the course of five years, this would save 25 billion euros.
(b) using revenue gained through taxes and the privatization of public assets to reduce indebtedness;
(c) balancing health insurance, retirement pension and unemployment welfare accounts. The 2009 deadline to balance the health insurance account has been deemed "imperative." Regarding retirement benefits, the 2003 pension reform plan designated 2008 be set as the year by which all conditions for the balancing of pension regimes, good until 2020.
(d) stabilizing central government transfers to local authorities to save 6 billion euros in four years.
(e) cutting inefficient expenditures by merging a number of redundant administrative authorities, modernizing administrations' human resources policies, and taking advantage of waves of retirements to dramatically cut the number of civil servants.

Comment

¶8. Analyses and recommendations of the Pebereau report are both accurate and alarming. It remains to be seen if warnings will be heeded or ignored. Candidates in the 2007 presidential elections may look to the report when working out their own electoral platforms or when criticizing those of their rivals. End comment.

STAPLETON